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Department of the Treasury

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Date: September 20, 2006

Bank =

Trust =

Grantor =

A =

D1 =

D2 =

D3 =

D4 =

D5 =

State =

Dear :

This letter responds to a letter dated May 22, 2006 submitted on behalf of Bank by its authorized representative, requesting certain rulings under the Internal Revenue Code.

The information submitted states that Trust was established by Grantor on D1 for the primary benefit of A. At the present time, Bank is serving as the sole trustee of Trust.

The trustee of Trust represents that no additions, actual or constructive, have been made to Trust after D2. A died on D3; he was not survived by any lineal descendants.

Article I, Section D(3) of Trust provides that if A dies without lineal descendants, A's income interest is divided among individuals named in 20 different subdivisions of Section D(3), labeled as subsections (a) through (t), with each subdivision having one or more persons designated to receive a 1/20th share of Trust's net income. Each subdivision of Section D(3) except subsection (t) provides that as each named beneficiary under one of the subsections dies, that beneficiary's interest passes either to another named individual or to that beneficiary's lineal descendants or heirs-at-law. In addition, except as to subsection (t), as each lineal descendant or heir dies, other lineal descendants or heirs-at-law succeed to the interest of the deceased descendant or heir-at-law. The two named beneficiaries under subsection (t) have both died, and, pursuant to the final paragraph of Section D the interest under subsection (t) passes in equal shares to the beneficiaries under subsections (a) through (s). Therefore, at this time, the net income of Trust is divided equally among 19 individuals or groups of individuals named in subsections (a) through (s).

Article I, Section E provides that in the event A dies leaving no lineal descendants, Trust is to terminate at the earlier of 50 years from D1 (the date Trust was formed) or upon the death of the last survivor of the beneficiaries specifically named in Trust. Trust will terminate on D4. Upon termination, Trust's estate is to be distributed free of trust to those beneficiaries entitled to receive Trust's net income in proportion to their share of Trust's net income.

Trust's primary assets are (percent) and (percent). To accommodate the beneficiaries who do not want to receive from Trust when it terminates, trustee proposes to seek an order from the local court authorizing trustee to divide Trust into two separate trusts. The terms of each separate trust would be identical to Trust, including the D4 termination date.

Trust beneficiaries will choose the separate trust in which they want to be beneficiaries. The interests of each current income beneficiary and that beneficiary's children and heirs-at-law who would succeed to that income interest if the income beneficiary dies prior to Trust's termination will all be assigned to the same separate trust. Each beneficiary's share of the separate trust will equal his or her fractional share of the total Trust income prior to division (determined in accordance with Article I, Section D(3)) divided by the combined fractional shares in total Trust income of all the beneficiaries of that separate trust. Each of the two separate trusts will be entitled to a fractional share of the total Trust assets equal to the combined fractional shares of the beneficiaries of that separate trust in the total Trust income immediately prior to division.

If the court authorizes the division of Trust into two separate trusts, the trustee proposes to distribute to each separate trust a portion of the total Trust assets equal in value to that separate trust's fractional share of the total Trust value (determined based on the

identity of the beneficiaries whose interest are being allocated to that separate trust and their respective interests in Trust). Trustee proposes to distribute those assets in a non-pro rata fashion. Specifically, as to the _____, the trustee proposes to divide most of the _____ in kind into two separate tracts pursuant to appraisals or division plans obtained from independent _____ consultants and approved by the local court. The first separate tract of _____, which will be distributed to the first separate trust, will have a value equal to the sum of the pre-division fractional shares in Trust of all beneficiaries of the first separate trust multiplied by the total value of the _____ so divided, while the second separate tract of _____, which will be distributed to the second separate trust, will have a value equal to the sum of the pre-division fractional shares in Trust of all beneficiaries of the second separate trust multiplied by the total value of the _____ so divided. The first separate trust is expected to retain most or all of the _____ assets received by it until termination. The trustee intends to liquidate as much of the _____ as possible of the second trust before the trust terminates. The remaining Trust assets will be distributed to each separate trust in such a fashion that the total value of all assets received by each separate trust is equal to that separate trust's fractional share of the overall Trust assets.

Trust is governed by the law of State. Under State law, a court has the authority to divide a trust with respect to all judicial proceedings commenced on or after D5.

Issue 1

Section 643(e)(3)(A) provides that in the case of any distribution of property (other than cash) to which an election under § 643(e)(3) applies, (i) § 643(e)(2) does not apply, (ii) gain or loss is recognized by the trust in the same manner as if such property had been sold to the distributee at its fair market value, and (iii) the amount taken into account under §§ 661(a)(2) and 662(a)(2) shall be the fair market value of such property.

Section 643(e)(3)(B) provides that any election under § 643(e)(3) applies to all distributions made by the trust during a taxable year and is made on the return of the trust for such taxable year.

Section 661(a) provides that in any taxable year a deduction is allowed in computing the taxable income of a trust (other than a trust to which subpart B applies), for the sum of (1) the amount of income for such taxable year required to be distributed currently; and (2) any other amounts properly paid or credited or required to be distributed for such taxable year.

Section 1.661(a)-2(f) of the Income Tax Regulations provides that if property is paid, credited, or required to be distributed in kind no gain or loss is realized by the trust (or the other beneficiaries) by reason of the distribution, unless the distribution is in satisfaction of a right to receive a distribution in a specific dollar amount or in specific property other than that distributed.

We conclude that Trust's distribution of assets to the two separate trusts occurring as part of the proposed division will not cause Trust or its beneficiaries to realize gain or loss, provided that Trust does not make an election under § 643(e)(3).

Issue 2

Section 1001(a) provides that the gain from the sale or other disposition of property is the excess of the amount realized over the adjusted basis provided in §1011 for determining gain, and the loss is the excess of the adjusted basis provided in §1011 for determining loss over the amount realized. Under §1001(c), the entire amount of gain or loss must be recognized, except as otherwise provided.

Section 1.1001-1(a) of the Income Tax Regulations provides that except as otherwise provided in subtitle A of the Code, the gain or loss realized from the exchange of property for other property differing materially either in kind or in extent, is treated as income or as loss sustained.

Rev. Rul. 56-437, 1956-2 C.B. 507, provides that a partition of jointly owned property is not a sale or other disposition of property where the co-owners of the joint property sever their joint interests, but do not acquire a new or additional interest as a result of the transaction. Thus, neither gain nor loss is realized on a partition.

In Rev. Rul. 69-486, 1969-2 C.B. 159, a non-pro rata distribution of trust property was made in kind by the trustee, although the trust instrument and local law did not convey authority to the trustee to make a non-pro rata distribution of property in kind. The distribution was a result of a mutual agreement between the trustee and the beneficiaries. Because neither the trust instrument nor local law conveyed authority to the trustee to make a non-pro rata distribution, Rev. Rul. 69-486 held that the transaction was equivalent to a pro rata distribution followed by an exchange between the beneficiaries, an exchange that required recognition of gain under § 1001.

State law authorizes a trustee on distribution of trust property or the division or termination of a trust, to make distributions in divided or undivided interests, allocate particular assets in proportionate or disproportionate shares, value the trust property for those purposes, and adjust for resulting differences in valuation.

Cottage Savings Association v. Commissioner, 499 U.S. 554 (1991), provides that an exchange of property results in the realization of gain or loss under §1001 if the properties exchanged are materially different. Properties exchanged are materially different if the properties embody legal entitlements "different in kind or extent" or if the properties confer "different rights and powers." *Id.* at 565. In Cottage Savings, the Court held that mortgage loans made different obligors and secured by different homes did embody distinct legal entitlements, and that the taxpayer realized losses when it exchanged interests in the loans. *Id.* at 566. In defining what constitutes a "material

difference" for purposes of §1001(a), the Court stated that properties are "different" in the sense that is "material" to the Code so long as their respective possessors enjoy legal entitlements that are different in kind or extent. *Id.* at 564-65.

In the present case, the beneficiaries are severing their joint interests under the Trust. However, because State law authorizes non-pro rata partitions, the proposed trust partition into the separate trusts with substantially identical terms and provisions will not result in the beneficiaries acquiring any new or additional interests. Therefore, the partition of the Trust is not a sale or other disposition of property, under Rev. Proc. 56-437, and does not result in a material difference in the legal entitlements enjoyed by the beneficiaries under Cottage Savings. Accordingly, no gain or loss is recognized on the partition of the Trust for purposes of § 1001.

In addition, the present case is distinguishable from Rev. Rul. 69-486. Unlike the disguised transaction situation presented in the revenue ruling, here State law authorizes non-pro rata partitions. Accordingly, the proposed partition will not be treated as a pro rata distribution followed by an exchange of assets among the beneficiaries of the original Trust.

The proposed division of the Trust will not constitute a taxable disposition under § 1001.

Issue 3

Section 2601 imposes a tax on every GST made after October 26, 1986. A GST is defined under § 2611(a) as (1) a taxable distribution, (2) a taxable termination, and (3) a direct skip.

Section 2612(a) provides that the term taxable termination means a termination (by death, lapse of time, or release of a power or otherwise) of an interest in property held in trust where the property passes to a skip person with respect to the transferor of the property. Section 2612(b) provides that the term taxable distribution means any distribution from a trust to a skip person other than a taxable termination or a direct skip. Under § 2612(c)(1), a direct skip is a transfer subject to federal estate or gift tax made by a transferor to a skip person.

Under § 1433(b)(2)(A) of the Tax Reform Act of 1986 and § 26.2601-1(b)(1)(i) of the Generation-Skipping Transfer Tax Regulations, the GST tax provisions do not apply to any GST under a trust (as defined in § 2652(b)) that was irrevocable on September 25, 1985, but only to the extent that the transfer is not made out of corpus added to the trust after September 25, 1985 (or out of income attributable to corpus so added).

Section 26.2601-1(b)(1)(ii)(A) provides that any trust in existence on September 25, 1985, is considered an irrevocable trust except as provided in

§§ 26.2601-1(b)(ii)(B) or (C), that relate to property includible in a grantor's gross estate under §§ 2038 and 2042.

Section 26.2601-1(b)(4)(i) provides that, in general, unless specifically provided otherwise, the rules contained in § 26.2601-1(b)(4) are applicable only for purposes of determining whether an exempt trust retains its exempt status for GST tax purposes. Thus (unless specifically noted), the rules do not apply in determining, for example, whether the transaction results in a gift subject to gift tax, or may cause the trust to be included in the gross estate of a beneficiary, or may result in the realization of gain for purposes of § 1001.

Section 26.2601-1(b)(4)(i)(D)(1) provides that a modification of the governing instrument of an exempt trust (including a trustee distribution, settlement, or construction that does not satisfy paragraph (b)(4)(i)(A), (B), or (C) of this section) by judicial reformation, or nonjudicial reformation that is valid under applicable state law, will not cause an exempt trust to be subject to the provisions of chapter 13, if the modification does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation (as defined in § 2651) than the person or persons who held the beneficial interest prior to the modification, and the modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust.

Section 26.2601-1(b)(4)(i)(D)(2) provides that for purposes of this section, a modification of an exempt trust will result in a shift in beneficial interest to a lower generation beneficiary if the modification can result in either an increase in the amount of a generation-skipping transfer or the creation of a new generation-skipping transfer. To determine whether a modification of an irrevocable trust will shift a beneficial interest in a trust to a beneficiary who occupies a lower generation, the effect of the instrument on the date of the modification is measured against the effect of the instrument in existence immediately before the modification. If the effect of the modification cannot be immediately determined, it is deemed to shift a beneficial interest in the trust to a beneficiary who occupies a lower generation (as defined in § 2651) than the person or persons who held the beneficial interest prior to the modification. A modification that is administrative in nature that only indirectly increases the amount transferred (for example, by lowering administrative costs or income taxes) will not be considered to shift a beneficial interest in the trust. In addition, administration of a trust in conformance with applicable local law that defines the term income as a unitrust amount (or permits a right to income to be satisfied by such an amount) or that permits the trustee to adjust between principal and income to fulfill the trustee's duty of impartiality between income and principal beneficiaries will not be considered to shift a beneficial interest in the trust, if applicable local law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust and meets the requirements of § 1.643(b)-1.

Section 26.2601-1(b)(4)(i)(E), Example 5 provides as follows. In 1980, Grantor established an irrevocable trust for the benefit of his two children, A and B, and their

issue. Under the terms of the trust, the trustee has the discretion to distribute income and principal to A, B, and their issue in such amounts as the trustee deems appropriate. On the death of the last to die of A and B, the trust principal is to be distributed to the living issue of A and B, per stirpes. In 2002, the appropriate local court approved the division of the trust into two equal trusts, one for the benefit of A and A's issue and one for the benefit of B and B's issue. The trust for A and A's issue provides that the trustee has the discretion to distribute trust income and principal to A and A's issue in such amounts as the trustee deems appropriate. On A's death, the trust principal is to be distributed equally to A's issue, per stirpes. If A dies with no living descendants, the principal will be added to the trust for B and B's issue. The trust for B and B's issue is identical (except for the beneficiaries), and terminates at B's death at which time the trust principal is to be distributed equally to B's issue, per stirpes. If B dies with no living descendants, principal will be added to the trust for A and A's issue. The division of the trust into two trusts does not shift any beneficial interest in the trust to a beneficiary who occupies a lower generation (as defined in § 2651) than the person or persons who held the beneficial interest prior to the division. In addition, the division does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust. Therefore, the two partitioned trusts resulting from the division will not be subject to the provisions of chapter 13.

In the present case, Trust was irrevocable on D2. It has been represented that no additions, actual or constructive, have been made to Trust after that date. The proposed modification of Trust is similar to the modification described in § 26.2601-1(b)(4)(i)(E), Example 5. Therefore, based upon the facts submitted and the representations made, provided the division is completed after D5, the proposed division will not shift a beneficial interest in Trust to a beneficiary who occupies a lower generation than the persons who held beneficial interests prior to the division. In addition, the division will not extend the time for vesting of any beneficial interest in Trust beyond the period provided in Trust. Accordingly, upon division of Trust the two separate resulting trusts will be exempt from GST taxes to the same extent that Trust currently is exempt from GST taxes, and neither the division of Trust nor the distribution of assets thereto in the manner proposed by the trustee will cause any loss of or change in the GST-exempt status of Trust or the two separate resulting trusts.

Except as specifically set forth above, no opinion is expressed concerning the federal tax consequences of the facts described above under any other provision of the Code.

This ruling is directed only to the taxpayers requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the power of attorney on file with this office, a copy of this letter is being sent to Bank's authorized representative.

Sincerely,

Bradford R. Poston
Senior Counsel, Branch 2
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)

Enclosures (2)
Copy of this letter
Copy for § 6110 purposes